14.05 Retained Earnings & Dividends

Retained Earnings (RE) represents the accumulated earnings since inception of the company that have not been paid out to shareholders in the form of a dividend. At the end of each accounting year, net income is closed into retained earnings. In addition, retained earnings is periodically reduced for dividends. There are three dates relevant to each dividend:

- **Declaration date** - the board of directors commits to the dividend.

RE	X	
Dividends Payable		X

- **Record date** - The shareholders at this date are identified as the ones entitled to the dividend

  (no Journal entry)

- **Payment date** - distribution is made to the shareholders of record.

Dividends Payable	X	
Cash		X

- **Types of Dividends**
  - Cash
  - Property (FMV @ date of declaration)
  - Scrip (Interest bearing Note Payable)
  - Liquidating (return of capital)
  - Stock - Small (FMV) / Large (Par)
  - Stock split

Cash Dividend	Scrip—Give dividend but no money	Stock Dividend
RE 25 Cash 25	RE 25 Note payable 25	Small < 20–25% – FMV RE 25 CS 20 APIC 5
	Partial Liquidating Dividend RE 15 APIC 10 Cash 25	Large > 20–25% – Par RE 20 CS 20
Property (FMV) RE 25 Asset 20 Gain 5	Person receiving Liq Div Cash 25 Div income 15 Investment 10	Stock Splits: Double shares, half par CS (10(10)) 100 CS (20(5)) 100

Net effect on Stockholders' Equity = 20

Note: All dividends reduce Stockholders' Equity except for stock dividends and stock splits.

The corporation charges retained earnings on the **declaration date** since the liability is created at that time.

For example, if the board declares dividends totaling $500 on 4/1/X1, payable on 4/28/X1 to shareholders of record on 4/21/X1, the entries are:

4/1/X1	Retained earnings	500	
	Dividends payable		500

This records the obligation. Identifying the actual payees doesn't change any account balances, so the next entry is on the **payment date**:

4/28/X1	Dividends payable	500	
	Cash		500

When a dividend exceeds the balance of retained earnings prior to declaration, the amount of the dividend in excess of retained earnings represents a return of contributed capital and is known as a **liquidating dividend**.

For example, if the board declares the $500 dividend on 4/1/X1 as above, but the balance in retained earnings is only $400 before recording the dividend, the entry is:

4/1/X1	Retained earnings	400	
	Additional paid-in capital	100	
	Dividends payable		500

When a company pays a dividend in the form of **property** other than cash, this is known as a **dividend-in-kind**. Such dividends are treated as simultaneous sales of property and distributions of cash, and results in gains or losses.

For example, assume the client declares a dividend-in-kind of land on 7/1/X1, payable on 7/15/X1. The land originally cost $300, is worth $800 on 7/1/X1, and $820 on 7/15/X1. The entry on the declaration date is:

7/1/X1	Retained earnings	800	
	Dividends payable		800
	Land	500	
	Gain on land		500

On the payment date, the entry is:

7/15/X1	Dividends payable	800	
	Land		800

The price appreciation after the declaration date is ignored, since the commitment to distribute the land effectively sells it.

Stock dividends are not actual distributions of assets from a company but represent transfers of capital from retained earnings to contributed capital accounts. Total stockholders' equity is unchanged. There are two types of stock dividends:

- **Ordinary stock dividends** – These are small stock dividends (typically less than 20%) and are recorded at the fair market value of the stock at the time of the dividend.
- **Stock splits effected in the form of stock dividends** – These are large stock dividends (typically more than 25%) and are recorded at the par value of the stock.

For example, assume a client has outstanding 100 shares of $10 par value stock with a fair market value of $30 per share. If a 5% (5 shares) stock dividend is declared and paid, it is reported at $30 per share:

Retained earnings	150	
Common stock		50
APIC-C/S		100

If a **100%** (100 shares) **stock dividend** is declared, it is reported at $10 per share:

Retained earnings	1,000	
Common stock		1,000

The reason for the difference is that the fair market value of the stock is not deemed to be a realistic estimate after a large stock dividend takes place, since it will substantially reduce the selling price of the shares. Dividends between 20% and 25% do not take place on the exam, since it is difficult to determine which classification they should have.

Stock splits in which old stock is exchanged for new stock are accounted for by adjusting the par value of the new shares for the split. If a 2-1 stock split occurred in the above situation, the 100 shares of $10 par stock would have been replaced by 200 shares of $5 par stock. Since total par value is unchanged, no entry is made. A reverse stock split does the opposite by reducing the number of shares outstanding and proportionally increases the par value.

Retained earnings are assumed to be available for the payment of dividends, so when a company faces contingent liabilities that may require large payments in the future, it will often **appropriate** a portion of the retained earnings to indicate to its shareholders its unavailability for dividend payments.

If a company wishes to appropriate $100,000 of retained earnings for possible losses related to pending lawsuits, the entry is:

Retained earnings-Unappropriated	100,000	
Retained earnings-Reserve for lawsuits		100,000

Notice that the above entry has no impact on net assets or net income, and doesn't actually change retained earnings, either. It is considered a disclosure on the face of the financial statements and is appropriate for reasonably possible costs or costs that are probable but not estimable. The above entry is not used for probable and estimable losses, which should be accrued on the income statement and reduce net assets.

When the reserve is no longer needed, the above entry is reversed. This is appropriate whether or not the costs actually occur, since the effects of the contingency will be reflected directly if and when they do result in losses.

In general, retained earnings may not be increased except when net income is closed into it. An exception is when a company has a **quasi-reorganization (fresh start)** (ASC 852). Since new companies always begin with retained earnings of $0, a company with a deficit in retained earnings has the ability to eliminate that deficit by reorganizing as a new company. Accounting principles, therefore, allow a company to restate its accounts as if they had reorganized. This requires shareholder approval.

Usually, a company involved in a quasi-reorganization will take the opportunity to adjust the carrying amount of assets to market values and may adjust the par value of the stock as well. If the entry doesn't balance, the difference adjusts APIC.

For example, assume a client has the following balance sheet:

Assets	900
Liabilities	200
$10 par common stock	800
APIC	500
Retained Earnings	(600)
Liabilities and stockholders' equity	900

They elect a quasi-reorganization. Assets are reduced to market value of $800, and the par value of the shares reduced to $5. The entry is:

Common stock	400	
APIC (balance)	300	
Assets		100
Retained earnings		600

The reason the par value of the stock is often reduced (as in this example) is that APIC cannot be debited for an amount that exceeds its balance before the quasi-reorganization.